Part I

Section 401.—Qualified Pension, Profit-sharing, and Stock Bonus Plans

(Also, §§ 402, 404A, 410, 414, 933, 7805; 26 CFR 1.410(b)-6, 1.414(*l*)-1, 1.933-1, 301.7805-1.)

Rev. Rul. 2008-40

ISSUES

1. Whether a transfer of amounts from a trust under a plan qualified under § 401(a) of the Internal Revenue Code[1] to a nonqualified foreign trust is treated as a distribution.

2. Whether this result is different if the transferee plan satisfies the requirements of section 1165(a) of the Puerto Rico Internal Revenue Code and is described in section 1022(i)(1) of the Employee Retirement Income Security Act of 1974.

FACTS

Situation 1. An employer maintains two retirement plans, Plan A and Plan B, each of which is funded through a trust. Plan A is a qualified plan under § 401(a). Plan A covers employees of the employer who perform all of their services within the United States and employees who perform all of their services within Country X. The Plan A trust is created and organized within the United States, and is classified as a U.S. person under § 7701(a)(30)(E). Plan B covers only Country X employees who perform all of their services within Country X, and is maintained for the exclusive purpose of providing retirement benefits to those employees. The Plan B trust is created and organized under the laws of Country X, and is classified as a foreign trust under § 7701(a)(31)(B). Plan B is not a qualified plan under § 401(a) (and would not satisfy the qualification requirements of § 401(a) even if the Plan B trust were a domestic trust). Plans A and B are each amended to provide for the assets and liabilities held in the Plan A trust on behalf of the Country X employees who perform all of their services within Country X to be transferred from the Plan A trust to the Plan B trust. There is no income tax treaty in force between the United States and Country X.

Situation 2. An employer maintains two retirement plans, Plan C and Plan D, each of which is funded through a trust. Plan C is a qualified plan under § 401(a)

[1] For purposes of this revenue ruling, unless otherwise indicated, all section references are to the U.S. Internal Revenue Code of 1986, as amended.

of the Internal Revenue Code, and also satisfies the requirements of section 1165(a) of the Puerto Rico Internal Revenue Code (Puerto Rico Code). Plan C covers both employees of the employer who perform all of their services within the United States and employees who are bona fide residents of Puerto Rico who perform all of their services within Puerto Rico. The Plan C trust is created and organized within the United States, and is classified as a U.S. person under § 7701(a)(30)(E). Plan D is a plan described in section 1022(i)(1) of the Employee Retirement Income Security Act of 1974 (ERISA) that satisfies the requirements of section 1165(a) of the Puerto Rico Code, but does not satisfy the requirements of § 401(a) of the Internal Revenue Code (and would not satisfy § 401(a) even if the Plan D trust were a domestic trust). Plan D covers only bona fide residents of Puerto Rico who perform all of their services for the employer within Puerto Rico, and is maintained for the exclusive purpose of providing retirement benefits to those employees. The Plan D trust is created and organized under the laws of Puerto Rico, and is classified as a foreign trust under § 7701(a)(31)(B). Plans C and D are each amended to provide for the assets and liabilities held in the Plan C trust on behalf of bona fide residents of Puerto Rico who perform all of their services within Puerto Rico to be transferred from the Plan C trust to the Plan D trust.

LAW

Section 401(a) provides that a trust created or organized in the United States and forming a part of a stock bonus, pension, or profit-sharing plan that satisfies the requirements set out in § 401(a) constitutes a qualified trust. Section 501(a) provides that a trust described in § 401(a) is exempt from tax under Subtitle A.

Section 401(a)(7) provides that a trust is not a qualified trust unless the plan of which it is part satisfies the requirements of § 411 (relating to minimum vesting standards). Section 411(d)(6)(A) provides that a plan is not a qualified plan if an employee's accrued benefit is decreased by any amendment of the plan, and § 1.411(d)-3(a)(1) of the Income Tax Regulations provides that a plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) if a plan amendment decreases the accrued benefit of any plan participant. For this purpose, a plan amendment includes any changes to the terms of a plan. Section 1.411(d)-3(a)(2)(i) provides that, for purposes of determining whether or not any participant’s accrued benefit is decreased, amendments to all the provisions of a plan affecting, directly or indirectly, the computation of accrued benefits are taken into account. Section 1.411(d)-4, Q&A-3(a)(1), provides that § 411(d)(6) protected benefits may not be eliminated by reason of a transfer or any transaction amending or having the effect of amending a plan to transfer benefits. Section 411(d)(6)(D) and paragraph (b) of § 1.411(d)-4, Q&A-3, provide an exception for elective transfers between qualified defined contribution plans, provided certain requirements are met.

Under § 401(a)(11)(B)(iii), the qualified joint and survivor annuity (QJSA) requirements of § 417 do not apply to certain defined contribution plans. Under § 401(a)(11)(B)(iii)(III), in order for a defined contribution plan to not be subject to the QJSA requirements for a participant, the plan cannot be a direct or indirect transferee of a plan that is subject to the QJSA requirements with respect to assets and liabilities that were transferred with respect to the participant.

Section 401(a)(12) provides that a trust is not qualified under § 401(a) unless the plan of which such trust is a part provides that, in the case of any merger or consolidation with, or transfer of assets or liabilities to, any other plan, each participant in the plan would (if the plan then terminated) receive a benefit immediately after the merger, consolidation, or transfer which is equal to or greater than the benefit he or she would have been entitled to receive immediately before the merger, consolidation, or transfer (if the plan had then terminated). Section 414(l) requires a plan to satisfy this minimum benefit requirement and also provides rules for how plan assets must be allocated. Regulations under § 414(l) treat a transfer of assets and liabilities from one plan to another as a combination of events that is fundamentally the same as a spinoff of a plan from the transferor plan followed by a merger of the spun off plan with the transferee plan. See §§ 1.414(l)-1(o), 1.414(l)-1(b)(4), and 1.414(l)-1(b)(2). Thus, as is the case for a plan that results from the merger of two plans, a transferee plan is a continuation of the transferor plan with regard to transferred assets and liabilities.

Section 402(a) provides that a participant's interest in a trust forming part of a qualified plan is includible in gross income in the taxable year in which it is distributed from the trust.

Section 402(c) describes rules applicable to rollovers from exempt trusts. An eligible rollover distribution is excluded from income if, among other requirements, the distribution is rolled over to an eligible retirement plan. Section 402(c)(8)(B) defines “eligible retirement plan” to mean (i) an individual retirement account described in § 408(a); (ii) an individual retirement annuity described in § 408(b); (iii) a qualified trust, i.e., an employees’ trust described in § 401(a) that is exempt from tax under § 501(a); (iv) an annuity plan described in § 403(a); (v) an eligible deferred compensation plan described in § 457(b) which is maintained by an eligible employer described in § 457(e)(1)(A); or (vi) an annuity contract described in § 403(b).

Section 402(d) provides that, for purposes of subsections (a), (b), and (c) of § 402, a stock bonus, pension, or profit-sharing trust that would qualify for exemption from tax under § 501(a) except for the fact that it is a trust created or organized outside the United States is treated as if it were a trust exempt from tax under § 501(a).

Section 404(a)(4) provides that, if a stock bonus, pension, or profit-sharing trust would qualify for exemption under § 501(a) except for the fact that it is a trust created or organized outside the United States, contributions to such a trust by an employer that is a resident, or corporation, or other entity of the United States, shall be deductible under the preceding paragraphs of § 404(a).

Under § 404A(e) and (f), a qualified funded plan is a written plan of an employer for deferring the receipt of compensation if: the plan is for the exclusive benefit of the employer's employees or their beneficiaries; 90 percent or more of the amounts taken into account for the taxable year under the plan are attributable to services performed by nonresident aliens and the compensation for which is not subject to tax under Chapter 1 of the Code; the employer elects to have section 404A apply to the plan; and the plan is not a funded reserve plan.

Section 933(1) generally provides that, in the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, income derived from sources within Puerto Rico (except amounts received for services performed as an employee of the United States or any agency thereof) is excluded from gross income and is exempt from tax under subtitle A of the Internal Revenue Code of 1986, as amended. See § 937(a) and the regulations thereunder for rules for determining whether an individual is a bona fide resident of any of the possessions of the United States, including Puerto Rico.

Section 937(b)(1) generally provides that rules similar to the rules for determining whether income is income from sources within the United States apply for purposes of determining whether income is from sources within a possession.

For purposes of determining the source of pension payments from a qualified trust under § 401(a), the portion of each payment that is attributable to employer contributions with respect to services rendered within the United States is treated as income from sources within the United States and the portion that is attributable to employer contributions with respect to services rendered outside the United States is treated as income from sources without the United States. For rules regarding the treatment of earnings and accretions with respect to contributions of either the employer or the employee, see Rev. Rul. 79-388, 1979-2 C.B. 270, and Rev. Proc. 2004-37, 2004-1 C.B. 1099. See also Clayton v. United States, 33 Fed. Cl. 628 (1995), aff'd without published opinion, 91 F.3d 170 (Fed. Cir.), cert. denied, 519 U.S. 1040 (1996).

Section 1022(i)(1) of ERISA provides that, for purposes of § 501(a), any trust forming part of a pension, profit-sharing, or stock bonus plan all the participants of which are residents of Puerto Rico is treated as an organization described in § 401(a), and therefore generally exempt from income taxation, if the trust both forms part of a pension, profit-sharing, or stock bonus plan and is exempt from income tax under the laws of Puerto Rico. For purposes of section 1022(i) of ERISA, a resident of Puerto Rico is either a bona fide resident of Puerto Rico or a person who performs labor or services primarily within Puerto Rico, regardless of residence for other purposes, and a participant is a current employee who is not excluded under the eligibility provisions of the plan. Section 1.501(a)-1(e). Section 1022(i)(1) of ERISA does not extend qualified status under § 401(a) to a plan, favorable tax treatment under § 402(a) for distributions to participants, or favorable treatment under § 404(a) for employer contributions.

Section 1022(i)(2)(A) of ERISA provides that if the administrator of a pension, profit-sharing, or stock bonus plan that is created or organized in Puerto Rico elects, at such time and in such manner as the Secretary of the Treasury may require, to have the provisions of, and amendments made by, Title II of ERISA apply, then, for plan years beginning after the date of election, any trust forming a part of the plan is treated as a trust created or organized in the United States for purposes of § 401(a) of the Internal Revenue Code. Section 1.401(a)-50 provides that plans created or organized in Puerto Rico whose administrators have made the election referred to in section 1022(i)(2) of ERISA are to be treated as trusts created or organized in the United States for purposes of § 401(a). Thus, in contrast to a plan under section 1022(i)(1) of ERISA, a plan for which an election under section 1022(i)(2) has been made is treated as a qualified plan for purposes of §§ 401(a), 402(a), and 404(a), even though the trust is created and organized in Puerto Rico and is classified as a foreign trust under § 7701(a)(31)(B).

Under the Puerto Rico Code, any retirement plan that covers Puerto Rican employees must satisfy the requirements of section 1165(a) of the Puerto Rico Code. Section 1165(a) of the Puerto Rico Code contains rules similar to the qualification requirements of § 401(a). However, there are many significant differences between the two sets of requirements, such as different definitions of a highly compensated employee, so that there are circumstances under which a plan sponsor may not be able to design a retirement plan that is assured of being able to satisfy both sets of requirements.

Revenue Ruling 67-213, 1967-2 C.B. 149, holds that, where the interests of participants are transferred from a trust forming part of one qualified plan to a trust forming part of another qualified plan, no amounts are considered distributed or made available to the participants by reason of the transfer.

Revenue Ruling 94-76, 1994-2 C.B. 46, describes a transfer of participant accounts from a § 401(a) qualified money purchase pension plan to a § 401(a) qualified profit-sharing plan that permitted distribution upon events that would not have been permitted under a qualified pension plan. The revenue ruling notes that, under the regulations issued under § 414(l), a transfer is the same as a merger of assets and liabilities of a qualified money purchase pension plan with the assets and liabilities of a qualified profit-sharing plan. Accordingly, the revenue ruling holds that the transfer does not divest the assets and liabilities of the money purchase pension plan of their attributes as pension plan assets and liabilities and that the transferee plan is disqualified if the transferred amounts fail to remain subject to the restrictions on distributions applicable to a qualified money purchase pension plan.

ANALYSIS

A transfer of assets and liabilities from one plan to another that constitutes a continuation of the transferor plan with regard to the transferred assets and liabilities is not a distribution of benefits. A nonqualified plan cannot be a continuation of a qualified plan. Accordingly, the holding described in Rev. Rul. 67-213 for a transfer from one qualified plan to another does not apply to a transfer from a qualified plan to a nonqualified plan. Under the facts in this revenue ruling (including the fact that the nonqualified plan is maintained for the exclusive purpose of providing benefits to participants or beneficiaries), the transfer is a distribution of the participant's or beneficiary’s beneficial interest in the transferor plan. Any such distribution would result in disqualification of the transferor plan if the distribution failed to satisfy the applicable qualification requirements (e.g., if any participant was not eligible for a distribution or if the transfer impermissibly eliminated rights protected under § 411(d)(6)).

Section 402(c)(8) lists the types of arrangements that constitute eligible retirement plans for purposes of excluding eligible rollover distributions from income under § 402(c), which does not include nonqualified foreign trusts. Section 402(d) provides that a nonqualified foreign trust is nonetheless treated as qualified under § 501(a) for purposes of § 402(c)(8) if it satisfies all of the qualification requirements of § 401(a) other than having a U.S. trust. Accordingly, a distribution to a nonqualified foreign trust is excluded from income under § 402(c) only if it is rolled over to a trust described in § 402(d).

Under the facts of Situation 1, the transfer of the assets and liabilities of the Country X employees from the Plan A trust to the Plan B trust is treated as a distribution from Plan A. In the case of a Plan B participant or beneficiary who is a nonresident alien, the portion of the distribution sourced to the United States (i.e., the earnings and accretions) is subject to 30-percent withholding under §§ 871(a) and 1441(a) unless the distribution is exempt under § 871(f) (relating to annuities from plans under which at least 90 percent of the employees are citizens or residents of the United States). In the case of a participant or beneficiary who is a resident alien (e.g., a green-card holder) or a U.S. citizen, the distribution is includible in the gross income of the participant or beneficiary to the extent applicable under §§ 402 and 72 (i.e., the distribution is includible in the gross income of the participant except to the extent it consists of investment in the contract).

Under the facts of Situation 2, the transfer of assets and liabilities of the Puerto Rican employees to the Plan D trust is treated as a distribution from the Plan C trust. If the distribution fails to satisfy the applicable qualification requirements, the distribution will result in disqualification of the transferor plan and is generally includible in the gross income of the participant or beneficiary to the extent applicable under §§ 402 and 72. In the case of a Plan D participant who is a bona fide resident of Puerto Rico (within the meaning of § 937(a)) who has performed all of his or her services for the employer in Puerto Rico, the source of the distribution for purposes of § 933 is based on the source of plan contributions and the source of earnings and accretions with respect to plan contributions. Accordingly, in Situation 2, with respect to the distribution from Plan C that results from the transfer, the portion of the distribution that is attributable to employer contributions to the plan is treated as income from sources within Puerto Rico, and the portion that represents earnings and accretions with respect to contributions of either the employer or the employee is treated as income from sources within the United States. Subsequent distributions to the employee from Plan D that are attributable to contributions made by the employer, along with post-transfer earnings and accretions with respect to employer or employee contributions, will be treated entirely as income from sources within Puerto Rico for purposes of § 933 provided that the Plan D trust remains a Puerto Rico trust and all of the employee's subsequent services covered by Plan D are performed within Puerto Rico.

By contrast, a transfer from a qualified plan to a plan that has made an election under section 1022(i)(2) of ERISA is not treated as a distribution from the transferor plan because a plan that has made an election under section 1022(i)(2) of ERISA is treated as a qualified plan for purposes of § 401(a). This conclusion only applies if the transfer is not part of a series of transfers or amendments under which assets and liabilities are subsequently transferred to a nonqualified plan.

For purposes of this revenue ruling, a transfer includes a transaction that is structured as a merger or consolidation.

HOLDINGS

1. A transfer of amounts from a trust under a plan qualified under § 401(a) to a nonqualified foreign trust is treated as a distribution from the transferor plan.

2. A transfer of assets and liabilities from a qualified plan to a plan that satisfies section 1165 of the Puerto Rico Code is also treated as a distribution from the transferor plan, even if the plan is described in section 1022(i)(1) of ERISA.

TRANSITION RELIEF

1. <u>Transfers to certain foreign plans before October 1, 2008.</u> With regard to a transfer from a qualified plan to a plan that would be a qualified funded plan under § 404A(f)(1) if the employer were to elect to have § 404A apply to the plan,

the holdings in this revenue ruling are not effective for a transfer made before October 1, 2008.

2. Transfers to plans under section 1022(i)(1) of ERISA. With regard to a transfer from a qualified plan to a plan described in section 1022(i)(1) of ERISA ("section 1022(i)(1) transferee plan") that would satisfy the requirements of § 414(l) but for the fact that the transferee trust is not a qualified trust within the meaning of § 401(a), the holdings in this revenue ruling are not effective for the transfer if the date of transfer is before January 1, 2011. In the case of a transfer to a section 1022(i)(1) plan with respect to which the holdings in this revenue ruling are not effective under the preceding sentence, the transfer is not treated as a distribution from the transferor plan and the transfer will not be treated as causing the transferor plan to fail to satisfy the requirements of § 401(a) solely on account of the holdings in this revenue ruling.

3. Application of § 933 to distributions from section 1022(i)(1) transferee plans. For purposes of § 933, the portion of each distribution from a section 1022(i)(1) transferee plan that is attributable to amounts that were transferred from a qualified plan before January 1, 2011, will be treated as income from sources within Puerto Rico.

4. Application of section 410(b) to U.S. plans of employers with excluded Puerto Rico employees. (a) Background. Section 410(b) requires the sponsor of a qualified plan to include all employees in testing coverage regardless of whether the employees benefit under the plan. Section 410(b)(3) provides certain exceptions to this coverage requirement, such as § 410(b)(3)(C) which permits the exclusion of nonresident aliens who receive no U.S.-sourced earned income from the employer. However, employees in possessions of the United States, such as Puerto Rico, are not excluded from coverage testing under § 410(b)(3)(C) because they generally are not nonresident aliens. Section 410(b) also precludes the aggregation of a nonqualified plan, such as a plan qualified only under the Puerto Rico Code, with a qualified plan for purposes of testing coverage.

(b) Relief. In accordance with § 7805(b), employees participating under a section 1022(i)(1) transferee plan may be treated as excludable employees for purposes of applying § 410(b) with respect to the transferor plan for plan years beginning prior to January 1, 2011. This relief is only available if either: (1) the U.S. plan would satisfy the requirements of § 410(b) if the U.S. plan and the section 1022(i)(1) transferee plan were aggregated for testing purposes, and the U.S. plan by itself would satisfy the average deferral percentage test of § 401(k)(3) (disregarding subparagraph § 401(k)(3)(A)(i)) and the average contribution percentage test of § 401(m), if applicable; or (2) in the case of a defined contribution plan that provides for contributions other than elective contributions (as defined in §1.401(k)-6), for employees benefiting under the section 1022(i)(1) transferee plan, the rate of such contributions following the date of the transfer is not reduced from the rate of such contributions under the transferor plan prior to the date of transfer.

EFFECT ON OTHER GUIDANCE

Rev. Rul. 67-213 is amplified.

DRAFTING INFORMATION

The principal author of this revenue ruling is Diane S. Bloom. For further information regarding this revenue ruling, please contact Ms. Bloom at RetirementPlanQuestions@irs.gov; for information regarding the sourcing of distributions under this revenue ruling, please contact Quyen P. Huynh at (202) 622-3880 (not a toll-free number).